

ANALYSIS OF ORIGINAL BILL

Author: Morrissey Analyst: Garnier Bill Number: AB 2131

Related Bills: See Legislative History Telephone: 845-5322 Introduced Date: 2-18-98

Attorney: Doug Bramhall Sponsor:

SUBJECT: Employee Health Insurance Deduction - 100% of Amount Paid

SUMMARY

This bill would allow employees not covered by a health insurance plan to deduct from gross income 100% of the cost of health insurance, up to the amount of employee's self-employed earned income.

EFFECTIVE DATE

As a tax levy, this bill would be effective upon enactment, but specifically becomes operative for taxable years beginning on or after January 1, 1998.

LEGISLATIVE HISTORY

AB 2107, AB 2131 (1998)

SPECIFIC FINDINGS

Existing federal law provides for a deduction in determining adjusted gross income (AGI) of 45% (effective for 1998) of a self-employed individual's cost for health insurance. Federal law also incrementally increases the deductible percentage over ten years to 100% beginning in the year 2007.

For taxable years beginning in 1997, the deductible percentage for self-employed health insurance costs, **under California law**, was 40% (SB 455, Stat. 1997, Ch. 611). For taxable years beginning on or after January 1, 1998, the California percentage reverts to the pre-1997 percentage of 25% (SB 1233, Stat. 1997, Ch. 612).

Under both federal and state law, "health insurance costs" include premiums paid for health insurance of the taxpayer, taxpayer's spouse and dependents. Qualified "long term care premiums" are also considered health insurance.

Additionally, **under both** federal and state law, a deduction for self-employed individuals is not allowed from gross income if the individual or individual's

DEPARTMENTS THAT MAY BE AFFECTED:

___ STATE MANDATE

___ GOVERNOR'S APPOINTMENT

Board Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
___ X ___ PENDING

Agency Secretary Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
DEFER TO ___

GOVERNOR'S OFFICE USE

Position Approved ___
Position Disapproved ___
Position Noted ___

Department Director Date
G. Alan Hunter 3/30/98

Agency Secretary Date

By: Date

spouse is eligible to participate in any subsidized health plan of any employer of the individual or individual's spouse. The deduction from gross income is limited to the extent of the individual's federal earned income from the business from which the health coverage was established.

Finally, **under both** federal and state law, the cost of health insurance incurred by a self-employed individual that is not deductible in determining adjusted gross income (AGI) may be taken as an itemized medical deduction. Itemized medical deductions are limited to the amount that exceeds 7.5% of the taxpayer's AGI. **Employees** may deduct health insurance costs paid by the employee, that are not excluded from income, as an itemized medical deduction, subject to the 7.5% AGI floor.

This bill would extend the deduction from gross income for the cost of health insurance to all employees with modifications. This bill accomplishes the extension of the deduction by applying the Internal Revenue Code section that permits the self-employed deduction to all employees. This methodology applies all the definitions, requirements and limitations, where applicable or not modified in this bill, used in the self-employed deduction to the employee deduction. For employees only, **this bill** would modify the 25% self-employed health insurance deduction to a 100% deduction.

As under the self-employed deduction, **this bill** would not allow a deduction for an employee if the employee or employee's spouse is eligible to participate in any subsidized health plan of any employer of the employee or employee's spouse. The same definition for "health insurance costs" used for self-employed individuals would apply to employees.

This bill would limit the dollar amount of the employee deduction to the federal "net earnings from self-employment" income (with minor modifications).

Policy Considerations

Employees who derive all of their income from wages and have no earnings from self-employment would not be allowed any deduction. Additionally, self-employed individuals with any wage income would be allowed to deduct 100% (subject to the self-employed income limitations) of their health insurance costs instead of the 25% limitation contained in current California law. This bill only modifies who may take the deduction without making corresponding modifications necessary to implement its provisions. This bill does not modify the self-employed deduction provision that limits the deduction to the "net earnings from self-employment."

Implementation Considerations

The department has identified the following implementation concern. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

The term "employee" is not clearly defined in the Revenue and Taxation Code, but employee is clearly defined in the Unemployment Insurance Code. To avoid any potential confusion the phrase "employee as defined under Section 621 of the Unemployment Insurance Code" should be included in this bill.

FISCAL IMPACT

Departmental Costs

The provisions of the bill would not significantly impact the department's costs.

Tax Revenue Estimate

Revenue losses from this provision are estimated to be as shown in the following table.

Fiscal Year Cash Flow Impact Effective 1/1/98 Enactment Assumed After June 30, 1998 \$ Millions		
1998-9	1999-0	2000-01
(\$4)	(\$5)	(\$8)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The revenue impact of this proposal is limited to taxpayers who meet all the following conditions: (1) must be self employed; (2) must have some wage or salary income; and (3) must pay 100% of their health insurance premiums. As a result of these restrictions, it is estimated that the number of taxpayers affected by this proposal would be approximately 30,000 in 1998.

This estimate was developed in the following steps. First, the number of California resident taxpayers who currently claim the self-employed insurance deduction was calculated from returns filed for 1995 (425,000). Second, the current deduction amount of 25% was calculated to be \$839 on average for returns filed in 1995, making the average annual health insurance premium \$3,356 (\$839 x 4). Third, the estimated number of qualified taxpayers for 1995 was grown at 5% per year to yield 492,000 qualified taxpayers for 1998. Fourth, the insurance premium was grown at 7% per year to yield an average \$4,111 insurance premium for 1998. Fifth, according to national data, approximately 6% of individuals have multiple jobs. Applying this percentage to the number of self-employed taxpayers,

generates 30,000 (492,000 x 6%) qualified taxpayers for 1998. This percentage was increased 2.5% per year to allow for taxpayer behavior under this bill to qualify for the 100% deduction. Sixth, based on the Departmental PIT Model, it was assumed that approximately 93% of the qualified taxpayers have Schedule-C income greater than four times the current medical deduction, and the remaining 7% have income less than four times. Therefore, it was assumed that 93% of qualified taxpayers would be entitled to deduct 100% of their insurance premium and the remaining 7% would be allowed to deduct 50%. Seventh, the total deduction at 25% was calculated to be \$31 million for 1998, and the amount deducted for health insurance premiums on Schedule-A was calculated to be \$24 million, generating a total deduction amount under current law of \$55 million. At an average marginal tax rate of 4.5% (computed by the PIT microsimulation model for self-employed individuals), the current law revenue loss for 1998 is \$2.5 million. Sixth, the total deduction under the proposal was calculated for qualified taxpayers to be \$122 million which at a 4.5% marginal tax rate, results in a \$5.5 million tax loss for 1998. These steps resulted in a 1998 estimate of an additional \$3 million tax loss. The 1998-9 fiscal year estimate consists of the 1998 tax loss (\$3 million) and 25% of 1999 reflecting reduced estimated tax payments.

BOARD POSITION

Pending.